

United States Environmental Protection Agency

Environmental Financial Advisory Board

on a proposed

Cooperative International Environmental Bond Guaranty Fund

The Board would like to propose a Cooperative International Environmental Bond Guaranty Fund (the “Cooperative Fund”). The purpose of this fund would be to provide, on a global basis, a contingent guaranty for bonds or loans which fund environmental projects. This guaranty would be contingent because participating countries would be required to fund a first loss reserve from the financial resources of their own indigenous environmental funds. The Cooperative Fund, whose capital would be furnished by the U.S. Government, would then assume a second loss position being each of the indigenous first loss providers. The Board proposes that, rather than restricting the operation of the program to one country or one group of countries, such program be available to all countries with emerging capital markets, which are willing to finance environmental infrastructure with municipal debt and which are willing either to create appropriate environmental funds or to use existing funds as a first loss reserve for bonds which the Cooperative Fund would guaranty.

The Office of International Activities has already made environmental bond guaranty proposals to Russia and the New Independent States (NIS) and to the Peoples’ Republic of China. In addition, the U.S. Agency for International Development has done work along broadly similar lines in several other countries, including Thailand, Indonesia, South Africa and the Czech Republic.

An illustration of how the Cooperative Fund might operate can be provided using a hypothetical National Ecological Fund (the “National Fund”) as an example.

This National Fund would have a reasonably reliable income source from effluent or emission permit fees or from fines and penalties. Under the instant proposal, the National Fund would set aside a specific amount of its funds in a trust to be used as a first loss guaranty on loans or municipal bonds issued for environmental projects, and the EPA-sponsored Cooperative Fund would take a second loss position on all qualifying loans or bonds guaranteed by the National Fund.

Now, assuming that this National Fund guaranteed four, five-million dollar bonds issued by municipalities which were counter-guaranteed by the municipalities’ respective creditworthy regional governments. Of these, \$20 million of bonds, assume that the National Fund were to pledge \$10 million as a first loss reserve. The Cooperative Fund would then guaranty an additional \$10 million in a second loss position. In order for the Cooperative Fund to sustain a loss, 1) three of the four municipalities would have to default, totally, on their obligations, 2) all

three of the, otherwise creditworthy, regional governments would have to abrogate, and default on, their counter-guaranties, and, 3) the National Fund would have to pay out all \$10 million of its first loss reserve.

As you can see, this structure would reward those municipalities which are creditworthy with lower interest rates and longer terms - hence less cash flow needed to pay for environmental projects. It would facilitate the development of municipal finance markets in each country where the guaranties are used, by clearly differentiating superior municipal credits and by permitting these credits to come to market in an orderly fashion. It would also involve a substantial financial commitment of the host government which should assure both local and international investor, as well as the U.S. Government, that municipal obligors will make good on their underlying financial obligations.

There is a further benefit to this structure.

If this double guaranty program is successful, it should be able to achieve substantial leverage. Although dollar-for-dollar guaranties will be required for the first \$100-\$200 million of projects, thereafter no further commitments should be required of the Cooperative Fund up to approximately 10x the combined funds available. In short, a commitment of \$100 million of U.S. funds should be able to leverage approximately \$2 billion of environmental infrastructure projects at any one time. Assuming an average five-year term for guaranteed bonds, the Cooperative Fund should be able to guaranty about \$6 billion of environmental infrastructure projects over a ten year period.

The Board proposes that \$100 million of U.S. Government funds be appropriated to capitalize the Cooperative Fund. It proposes that the Cooperative Fund be organized as an independent corporation whose shares are held by the U.S. Treasury. The Cooperative Fund should be headquartered in a major international financial center such as London or New York. It should have a board of directors appointed by the Administrator of the U.S. Environmental Protection Agency, the Secretary of State and the Secretary of the Treasury, or whomsoever the President directs. Finally, it should be staffed by a small cadre of professionals recruited from the financial guaranty insurance industry.

The Board views the actual creation and organization of the Cooperative Fund as a relatively straightforward matter. Implementing its goals, however, will take considerable work.

Successful implementation will involve five major technical assistance efforts. First, it will involve familiarizing the senior management of indigenous environmental funds with the benefits of a programmatic financing mechanism capable of accessing the international capital markets - thus achieving the longest possible terms at the lowest possible rates. Second, it will involve persuading senior government policy makers - in each country having an environmental fund - of the same benefits. Third, it will involve training the staffs of these indigenous funds on the operation of financial guaranties and the credit criteria required of the underlying municipal debt

issuers. Fourth, it will involve the training of municipal finance officers from each county in project finance methodology and municipal credit requirements for environmental infrastructure projects. Fifth, it may also involve working with legal, financial and regulatory authorities within certain countries to assure the proper legal and administrative procedures are in place for fully effectuating bondholders rights and the rights of the respective funds.

In this regard, much reliance would have to be placed on the Office of International Activities whose staff has developed strong rapport with the senior management of many of these environmental funds in other countries. They would also have to be relied upon for the significant work of persuading senior government policy makers of the wisdom of using their indigenous environmental financial resources for these purposes.

As far as the training of indigenous environmental fund credit personnel, foreign municipal finance officers, and foreign legal and regulatory officials is concerned, the Environmental Finance Centers, under the supervision of the Office of the Comptroller, could be of invaluable assistance in organizing such an effort. As you know, within the United States there are several states which offer financial guaranties on municipal bonds of various types. There are also six major, private financial guaranty insurance companies which offer such guaranties. A well-considered technical assistance program with a quasi-academic component and a practical component - organized by the Centers - could provide the staffs of these indigenous environmental funds and appropriate municipal finance officers from their respective countries with the fundamentals of municipal finance, environmental project finance and the administration of bond guaranties, which they need to successfully issue municipal bonds and to operate their own guaranty funds. Furthermore, the Centers are capable of organizing the legal, administrative and regulatory resources needed to train foreign government personnel in these matters, as well. The Environmental Finance Center at the Maxwell School at Syracuse University is especially well positioned to assist in these matters.

In summary, the creation of a permanent international financial institution, such as the Cooperative Fund, will give authoritative U.S. leadership and direction to the many countries struggling to establish permanent, viable systems for financing their environmental infrastructure. This benefit cannot be understated. It will firmly establish the leadership of the United States in the vital and emerging area of environmental finance. This leadership position will be especially significant as the international environmental community struggles to deal with the vast financial implications of issues such as global warming - where there is much to be learned from financial structures such as those proposed for the Cooperative Fund.

In addition, the Cooperative Fund will lower the cost of environmental infrastructure projects for emerging market countries across the globe. It will have positive effects in Eastern Europe, Africa, Asia and Latin America - wherever the financing of such projects is beginning to devolve from strict central government control. It will aid countries caught in the current miasma created by the turmoil in the emerging market financial crisis. The Cooperative Fund would especially assist countries such as the Baltic Republics in emerging from the penumbra of the

Russian financial implosion.

The Cooperative Fund will advance the U.S. Government's international efforts to achieve transparent fiscal procedures and serious financial market reform. Achieving access to international capital markets is a vague and ill-defined goal for many developing nations. All the more so for regions and municipalities within such countries. Proposals such as the Cooperative Fund give a clear direction to these goals. The Cooperative Fund will spell out for these developing countries the ABCs of the legal, administrative and fiscal disciplines necessary for a small city in a third world country to enjoy the considerable financial benefits of the longest bond terms and the lowest bond rates only available in the international capital markets. Furthermore, it will show them that the people of the United States are backing up our free advice with our valuable financial resources. And, we are doing so with great leverage - where billions of dollars of benefits will flow from the investment of just \$100 million of U.S. Government funds.

Finally, and most importantly for the U.S. Environmental Protection Agency, the Cooperative Fund will provide significant worldwide environmental benefits. It will put safe, drinkable water in the households of millions of people. It will remove the open sewage from many of the planet's most important waterways. It will clean filthy air from major cities. And it will provide a safe disposal for millions of tons of solid waste that plague the globe.

In sum, the Cooperative Fund will confer broad benefits not only on the people of the countries in which it operates, but also on the people of the United States and the world at large. For these reasons, we commend the Cooperative Fund proposal to you for your utmost consideration.